IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,

Petitioner,

vs.

RELIANCE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE DAVID MORGULAS IN SUPPORT OF RESPONDENT

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To the Honorable Supreme Court of the United States

The Interest of the Amicus Curiae

Your amicus curiae represents The Association of Casualty and Surety Companies, a non-profit trade association consisting of one hundred thirty-six capital stock companies, most of which write surety bonds nationally not only in connection with public works contracts and other surety bond requirements of the United States of America but also in connection with private, State and Municipal improvements contracts. The member companies of The Association write at least 85% of the annual volume of surety bonds written throughout the United States. A decision against the surety by this Court in the instant case will have

a profound bearing upon the long standing underwriting concepts and practices of The Association's member Companies and other surety bond underwriters and, as a necessary consequence, on both the number of bidders qualified by them on Federal contracts, and the overall cost of the work.

Preliminary Comment

This case involves the relative rights of a government contractor's Miller Act surety which has expended approximately $350,000. in payment of labor and material claims vis a vis a trustee in bankruptcy (representing the interests of general creditors of the contractor-bankrupt) in the retained balance of $87,737.35 on the bonded contract. Unlike the *Munsey Trust Case,* 332 U. S. 234, upon which the appellant trustee relies, this case does not involve any contest between the surety and the government's superior equity in such balance. The government has no present interest in such funds.

The court may take judicial notice of the genesis of the fund. It represents (at least until the 50% completion point), 10% of the monthly amounts claimed and allowed to the contractor for work (in essence labor and material) performed during the preceding months. (See Article 7 of GSA Standard Form 23A, General Provisions of Construction Contract.) In the instant case, the contractor in legal effect had physically performed the work but had left substantial bills for labor and material unpaid which the surety, because of the contractor's default in payment, satisfied completely under its payment bond obligation.

The sole question in this case is "Who is entitled to the retainage, the surety which met all the obligations of its bonds, on which it bound itself at the inception of the contract as required by Miller Act, or the trustee in bankruptcy representing general creditors of the contractor for debts unconnected with the government contract?".

THE ARGUMENT

POINT ONE

The rights of a Miller Act surety to contract balances have their origin in the surety's overriding equities.

The origin of the surety's right to reimbursement out of retained contract balances rests in part in contract and more basically in early judicial recognition of the all pervasive equitable nature of the surety's claim. Since the earliest of the relevant decisions in 1896 there has been a proliferation of rather technical discussions of subrogative rights, variations of contractual obligation and an attempt to apply more or less schematic methods in determining the surety's rights. Notwithstanding the specific rationale of each case, the decisions most generally are premised upon a conscious attempt to apply equitable doctrine.

The first of such decisions was the leading case of *Prairie State National Bank* v. *U. S.*, 164 U.S. 227, at page 233, when this Court said:

> "That a stipulation in a building contract for the retention, until the completion of the work, of a certain portion of a consideration, is as much

for the indemnity of him who may be guarantor of the performance of the work as for him for whom the work is to be performed; that it raises an equity in the surety in the fund to be created; and that a disregard of such stipulation by the voluntary act of the creditor operates to release the sureties, is amply sustained by authority."

See also: *National Surety Co.* v. *County Board of Education*, 15 F. 2d 993 (C.C.A. 4); *Ft. Worth Independent School District* v. *Aetna Casualty and Surety Co.*, 48 F. 2d 1 (C.C.A. 5), cert. den. 284 U.S. 645; *American Surety Co.* v. *Sampsell*, 327 U.S. 269.

The reason for this position becomes quite clear when it is realized what would happen if, instead of completing the contract in *Prairie State* the surety had elected simply to pay damages. In this latter event it would have been liable for no more than the difference between the amount paid by the owner for completion and the contract balance in the owner's hands at the time of completion. If, by sitting it out, the surety would receive the benefit of the contract balance, then clearly by actively "doing more" it should be in no worse position. See *Lacy* v. *Maryland Casualty Co.*, 32 F. 2d 48, 51 (4th Cir., 1929).

It must be remembered, in this connection, that at the time of *Prairie State*, "payment bond" obligations, if they existed at all, were written as part of the performance bond, as was the case under the Heard Act from the time of its enactment in 1894. The separation of the performance and payment covenants of the Heard Act bond into two distinct instruments by the Miller Act in 1935 was a pro-

cedural reform for the convenience of labor and material claimants and was not intended to enlarge the surety's liability. That such was the case was recognized by this court in *Clifford MacEvoy Co. v. U. S.*, 322 U.S. 102 (1944) and by Judge Medina in the opinion below. It is an interesting bit of history that as early as 1914, this court in *Equitable Surety Co.*, v. *McMillan*, 234 U.S. 448, 454, 456, in ruling on the District of Columbia counterpart of the Heard Act and its bond form, explicitly approved federal and other state court holdings that the two agreements for performance of the contract and payment of labor and material contained in a single bond "are as distinct as if contained in separate instruments."

The same rationale supporting the surety's equity applies in the case of payment of labor and material bills under the payment bond; for if the surety were to refuse to pay such bills voluntarily and without suit during the progress of the work, the contractor would undoubtedly be forced to default. If the surety then undertook, or arranged for completion, it would in the capacity of a "performance" surety be paying the claims of subcontractors and labor and materialmen in order to keep the project moving to completion. Under such circumstances, even the Appellant concedes the surety's full right to any contract balance in the government's hands. This analysis demonstrates how unrealistic it is to attempt to make the surety's right to the retainage on the job turn on whether the obligations it satisfied were liabilities under its performance bond or under its payment bond. Insofar as the surety is concerned its payments are but the two sides of the same coin, the obligations it undertook as surety. The surety's payments came

from the same pocket because the performance bond and the payment bond surety *is always the same.* The surety executes both bonds as a package of coverage and the same indivisible premium pays for the whole package.

However, this simple, but realistic analysis has been obscured by the attempts to discover a doctrinal framework within which the strongly perceived equity of the surety could be sustained.

Henningsen v. *United States Fidelity & Guaranty Co.*, 208 U.S. 404 (1908), was the second recognition by this Court of the surety's priority but in a fact situation where the surety had expended monies under the "payment" covenant rather than the "performance" covenant of the bond. At the root of the decision, however, was the equitable right first perceived and declared in *Prairie State* (see 208 U.S. at 411) to which the *Henningsen* court referred in the following language (after stating that the merits turn "upon the respective equities of the parties"):

> "The guaranty company was surety on that contract. Its stipulation was not merely that the contractor should construct the buildings, but that he should pay promptly and in full all persons supplying labor and material in the prosecution of the work contracted for. He did not make this payment, and the guaranty company, as surety, was compelled to and did make the payment. Is its equity superior to that of one who simply loaned money to the contractor, to be by him used as he saw fit, either in the performance of his building contract or in any other way? We think it is. It paid the laborers and materialmen,

and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that the laborers and supply men were paid. It did this not as a volunteer, but by reason of contract obligations entered into before the commencement of the work."

The difficulties which have arisen in the area of Federal contracts stem entirely from the not unnatural desire of the courts to rationalize decisions in doctrinal rather than equitable terms. But at the core of every decision in this area may be found a fundamental recognition of the surety's equitable right to the fund which has been, in fact, created by its very presence as guarantor (without which the contract could not even be awarded in the first instance), and secured by the fulfillment of its obligations to the labor and materialmen from whose contributions to the project the retained fund actually derives.

In point of fact, there is no distinction in this regard between a surety functioning as a "payment" surety and one actually completing physically uncompleted work under a performance bond. This point is illustrated in *Maryland Casualty Co.* v. *U. S.*, 100 C.Cls. 513, 521-2.

"The effect of the contract and the bonds is that the contractor promises the Government that it will build the structure, *and* will pay the laborers and materialmen. The Government takes two separate bonds to secure the fulfilment of these promises, since its interest in the first is

more physical and direct than in the second. But when the surety pays the laborers and materialmen it is performing the contract as much as when it completes the building."

This insistence on finding a "legal" rationale for what was without question an "equitable" result gave rise to many variations of the subrogation theme.

In *Farmers Bank* v. *Hayes et al.*, 58 F. 2d 34 (C.C.A. 6), the Court, holding for the surety, said:

"This is on the principle that a surety who gives bond to the owner to insure performance of a building contract by the contractor is subrogated to the rights of the *owner* in the percentage which the owner retains as security for the performance of the contract when upon default by the contractor the surety performs, as in the Prairie State Nat. Bank case, or on the principle that when the contractor performs his obligation to the owner, but fails to pay labor and material men, and the surety is obliged to do so under his bond the surety is subrogated to liens of laborers and materialmen upon the fund reserved by the owner."

"Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404; Belknap Hardware Manufacturing Company v. Ohio River Contract Company, 271 Fed. 144; Exchange State Bank v. Federal Surety Company, 28 Fed. (2d) 485 (C.C.A. 8)."

And in the case of *Richards Brick Co.* v. *Rothwell*, 18 App. D.C. 516, 537 (1901), the Court formulated

the rule, as applied to a payment bond situation, in the following manner:

"There is, therefore, by necessary implication, an equitable lien and preference secured in favor of the parties who furnish labor and materials in the execution of the contract, in the application or distribution of the contract price remaining to be paid; and where the government, as in the present instance, holds in its hands any part of the money contracted to be paid for the work, and there remain unpaid claims for labor and materials supplied, it holds such fund as quasi trustee for the benefit of those entitled to receive it under the condition in the bond; that is to say, the laborers and materialmen remaining unpaid. This right to preference being the result of the operation of the statute and the condition of the bond, it is the clear right, upon the plainest principles of justice, of the sureties in the bond to invoke a court of equity to enforce the preference and equitable lien for their protection. In construing this act of Congress of 13th August, 1894 [the Heard Act], this court said, in the case of Marble Company v. Burgdorf, 13 App. D. C. 506, 519 (1898):

'The practical effect of the statute is to confer a special lien in favor of such persons, (parties furnishing labor and materials) and to substitute the bond, in the place of the public building, as the thing upon which that lien is charged.'

"That is to say, the bond is liable rather than the building upon which labor and materials are used in construction; and if the sureties should

pay claims for such labor and materials for which they may be responsible on the bond, they have a right, upon well-settled principles, of substitution to such claims as against the contract price of the work remaining due to the contractor. And having such right of substitution, the sureties have a right to interpose to prevent the diversion or misapplication of the fund, and to require it to be paid out to the parties entitled to receive it in the first instance by virtue of the lien and preference given by operation of the statute."

It is to be noted that throughout the *relevant* decisions, of which the foregoing are only a small number, the terminology employed continues to shift—the words used are such as "special lien" "equitable priority"; "equitable lien", etc.—all of which merely formalize the underlying principle. See Jordan, "The Rights of a Surety upon the Default of Its Contractor Principal", 41 Oregon Law Rev. 1, 13.

The fundamental equities of the situation have been expressly recognized as controlling over technical constructions. In the case of *Massachusetts Bonding & Insurance Co. v. State of New York*, 259 F. 2d 33, a highly analogous factual situation was present. The surety paid out substantial sums to labor and materialmen to keep the contractor on the job so that it was actually completed before bankruptcy occurred. The Court cut through the technical arguments raised by the United States and State of New York, both of which were asserting tax liens, and said:

"The questions here are whether the bankrupt defaulted so as to bring into operation the rights of the surety, and if so, whether these rights to

payments from the owner take priority over tax claims of the State of New York and the United States. Both the State and the United States vehemently argue that the default contemplated in the contract between the bankrupt and the surety never occurred, and hence the assignment never matured; nor did the surety acquire a lien by way of subrogation. To some extent the arrangement created by the bankrupt and the surety whereby construction costs were paid out of the joint account into which they deposited progress payment supports this argument, for nominally the bankrupt continued its operations subject only to financial supervision by the surety. In this way construction activity never ceased and bills were paid without material delay. *But to analyze these facts so as to deprive the surety of its claim based on subrogation when it actually provided over $130,000 of its own money to pay laborers and materialmen is too technical to warrant serious consideration.* Cf., *Century Cement Mfg. Co. v. Fiore*, 261 App. Div. 475, 36 N.Y.S. 2d 332. The nub of the bankrupt's default was its inability to continue paying its bills. Whether the surety stepped in prior to or after the bankrupt failed to pay these bills is of little moment. The important fact is that the surety expended large sums of its own money to complete the contracts for which it has not been recompensed. (emphasis added).

POINT TWO

***American Surety Co.* v. *Hinds*, 260 F. 2d 366 (10 Cir. 1958) completely misconstrued both this Court's holding in *U. S.* v. *Munsey Trust Co.*, 332 U.S. 234 (1947) and the existing law governing the equities of a surety seeking reimbursement, and reached a totally erroneous conclusion.**

It was not until *American Surety Co.* v. *Hinds*, 260 F. 2d 366 that any court hurdled these and other long established equitable determinations and reached an opposite result by dint of a highly technical and, it is submitted, wholly incorrect application of a theory apparently suggested by, but by no means stated in *U. S.* v. *Munsey Trust Co.*, 332 U.S. 234. (1947).

Drawing upon the language in *Munsey*, which was directed towards a totally different problem where the government was not a stakeholder and had asserted a superior equity, the *Hinds* Court waved aside those distinguishing features in the two cases—the very ones which this Court emphasized as differentiating *Munsey* from any other case previously before it for decision.

The Tenth Circuit overlooked that *Munsey* represented a fact situation where the normal and traditional equities of the surety in contract funds (discussed in Point One above) had been displaced by a superior equity (a right of offset) in the government by reason of its dual position as a debtor and a creditor of the contractor, a superior equity which was forti-

fied by the statutory power of the Court of Claims and by "logical implication" of the Comptroller General to settle accounts by and against the government. See *Munsey*, pages 239-240. Furthermore, the Tenth Circuit failed to perceive that under the facts in *Hinds* it was a non sequitur to hold that because the surety's equity in the *Munsey* situation was displaced by the paramount equity and statutory position of the government, that, therefore, the surety had no equitable right in the funds superior to those of complete strangers to the contract from which the funds in issue, and the surety's loss, arose. We respectfully submit that this Court should not countenance such an inequitable interpretation of its holding in *Munsey*.

Another deficiency in the position taken in *Hinds* lies in the Court's assumptions that the surety could assert "no equitable claim to the fund itself, either in its own right or through the United States".

Having just discussed our difficulties in understanding the court's illogical assumption as to the absence of the surety's right to the fund "in its own right", we now turn to its further assumption that there was no right assertable "through the United States". The Court entirely failed to discuss "Whether the contractor's failure to pay labor and material did not constitute a breach of contract with the United States?" This facet of the surety's right to the funds arises from the contract documents when viewed as a whole and was marked out by Mr. Justice Cardozo in *Martin v. National Surety Co.*, 300 U.S. 588, discussed below.

The Miller Act, 40 U.S.C. 270 a-d, requires as a condition precedent to the award of any contract that

a payment bond in the statutory sum be furnished. By the specific language of the bond (GSA Standard Form 25A), the contractor engages to the government that all labor and materials shall be paid. This promise, being simultaneously effective with and required as a condition precedent to the award of the contract, is an integral part of that contract. Thus a failure by the contractor to pay labor and material bills is, quite specifically, a breach of his contract with the government.

This court so held in the case of *Martin v. National Surety Co.*, 300 U.S. 588 at p. 597:

> "But the statute directs that a bond for the prompt payment of materialmen and laborers shall be executed by the contractor before the commencement of the work. Not only that, but the contract with the Government, which was drawn in the standard form is a confirmation and adoption of the statutory duty. *The terms of the bond are read into the contract, and there is a default under the contract when there is default under the bond.*" (597-8). (emphasis added)

Thus, even if we follow the language and reasoning of the Court in *Hinds* to the effect that retained percentages are held by the government only to insure "performance" of the contract, we must reach the same result—for payment of labor and materials is as much an element of performance, by virtue of the promise made in the bond, as though it were spelled out in the contract itself. And once the government's right to invoke a breach for non-payment has been obviated by the surety's action, the surety is entitled, by "subrogation" to the same right the government

had to use the retainages to ensure performance. Cf. *U.S.F. & G. Co. v. Triborough Bridge*, 297 N.Y. 31; *Aetna Casualty & Surety Co. v. Horticultural Service*, 4 N.Y. 2d 639.

Furthermore, as a result of such breach, the contractor has no property right in the unpaid balances which can be claimed by the trustee standing in his shoes. *F. H. McGraw Co. v. Sherman Plastering Company*, 60 F. Supp. 504; *U. S. Fid. & Guar. Co. v. U. S.*, 92 C. Cls. 144; *Martin v. National Surety Co.*, 300 U.S. 588; *In re Duncan*, 127 F.2d 640 (CCA 3); *Karno-Smith v. Maloney*, 112 F.2d 690 (CCA 3).

A word about *Phoenix Indem. Co. v. Earle*, 218 F.2d 645 (9th Cir. 1955), which is also relied on by the Appellant. Firstly, the case involved the status of the United States as a tax lienor vis a vis the surety. As such the government enjoyed all the advantages of its tax status as against a so called "unperfected lien". Secondly, and most importantly, the fact situation in the case (page 648) plainly shows that on July 29, 1951, the Collector of Internal Revenue filed a proof of claim in bankruptcy based upon previously filed liens in the amount of $12,486. The Collector, however, failed to notify the Bonneville Power Administration (an agency of the United States) of the existence of the offset claim and, thus uninformed, the Administration on January 18, 1952 proceeded to pay to the trustee in bankruptcy the sum of $11,838.61. Had the Administration been aware of the offset, it could and would have enforced it with complete impunity under *Munsey* and other decisions of the Court. (See e.g., *Cherry Cotton Mills v. U. S.*, 327 U.S. 536.) Thus in reaching its decision the Ninth Circuit was simply following the classic equitable

doctrine of "regarding as done what should have been done". Considered in this light, *Phoenix* can have no application whatever to the problems presented in the instant case.

POINT THREE

Retainages are held by the Government not only to ensure "performance" in the sense the term is used by the *Hinds* Court, but to ensure payment as well. Payment is an inextricable element of performance, and the economic benefits derived by the Government from the payment bond are as important as physical completion.

Assuming, arguendo, that a failure to pay labor and material bills was not actually a breach of contract (compare, *Martin* v. *National Surety*), the result must in any event be the same. The Court in *Hinds* not only overlooked the breach of contract principle of the *Martin* case but also proceeded on the incorrect assumption that the Government derived no direct benefit from the presence of the payment bond. Therefore, the court dubiously concluded, the retained percentages were held *solely* to protect the Government's interest in performance of the contract and, by subrogation, to provide reimbursement for the surety completing physical "performance" of the contract work under its performance bond but not for payments made pursuant to its payment bond.

The existence of considerable economic benefits derived by the Government from the payment bond negates so limited an assumption. Principal among

these benefits is a general lowering of subcontractor and material bid prices as a result of the bond's assurance that payment will be made and the consequent lack of incentive to "weight" or "hedge" prices against dubious credit risks. This point was made by this Court in *Equitable Surety Company v. McMillan*, 234 U.S. 448 at p. 456:

> "The public is concerned not merely because laborers and materialmen (being without the benefit of a mechanic's lien in the case of public buildings) would otherwise be subject to great losses at the hands of insolvent or dishonest contractors, but also because the security afforded by the bond has a substantial tendency to lower the prices at which labor and material will be furnished, because of the assurance that the claims will be paid."

See also Cushman, Surety Bonds on Public Construction Projects, 46 A.B.A.J. 649.

In a highly relevant article in 27 Fordham Law Review (1958), p. 262 at 270-71, the following analysis appears:

> "To ascribe to the public corporation wholly unselfish motives in exacting the payment bond, is to ignore commercial realities. The possibility of a lien may be only one of the motives for exacting a payment bond. There are other motives, common to both a private party and to a governmental unit. First, the reduction in expense for credit investigation and bad debt losses, not only making it possible for the subcontractor or materialman to charge a lower price, but also

inducing competition by subcontractors and materialmen who might not otherwise wish to compete with a consequent lower bid by the contractor. Second, the assurance of steady progress of the work in the case of default by the contractor, since unpaid laborers and materialmen can look to the bond for compensation. Third, the avoidance of the annoyance and risk of withholding payments to the contractor in favor of unpaid laborers and materialmen should the contractor default. Even without the possibility of a lien, these commercial advantages seem motive enough for the owner to insist on a payment bond from the contractor."

See also Reconsideration of Subrogative Rights of The Miller Act Payment Bond Surety, 71 Yale Law Journal 1274, 1279, n. 28.

Thus to say that the only purpose for which the Government holds the 10% contract retainer and any relevant contract balance is solely to ensure completion of the contract on time and to predicate thereon a denial of the rights of an out-of-pocket surety on a payment bond is simply to deny the economic realities of the problem. Inasmuch as the property of the sovereign is immune from mechanic's liens and similarly immune from any form of suit on implied contract by subcontractors, some substantial security must be offered to subcontractors and material suppliers to induce their participation in public work. Therefore, the government has since 1894 required that they be afforded bond protection. The premiums for such bonds form a part of the bid price on all such contracts and, although the contractor is required to

furnish the bond, the government is in reality, as we have seen above, subserving more than a moral obligation to labor and material when it in effect purchases protection for them and for itself. Without such protection it is highly doubtful that any kind of truly competitive pricing could be achieved on government work as prudent subcontractors and materialmen, of necessity, would hedge their bids against the possibility of non-payment by government contractors and government contracting officers would have no objective assurance that the successful bidder was "responsible".

Simultaneously with the payment bond, the government also requires a performance bond, thus assuring itself of completion within a fixed and predetermined cost (the contract price). If subcontractors, labor and materialmen, are not paid promptly, it is reasonable to expect that they will refuse to progress the job and thereby precipitate the general contractor's default. If the government's interest in completion "on time" is to be served, it is performance under both the "payment" and the "performance" bond which will best serve its needs. Thus, in point of fact, the "payment" bond is required to buttress one of the basic obligations of the contractor's performance, i. e., *timely* completion.

And what of the retained percentages? Surely if these funds are held by this court as against general creditors of the contractor to be unavailable to the surety for reimbursement, the surety has nothing to look to and has no interest in performing under the "payment" bond. Rather, it will have a strong financial incentive to stand by and allow a shaky con-

tractor to default and then take over performance of the contract itself, thereby assuring itself of recourse to the contract balance. The Surety should not be forced into such a procedure since in the role of a "performance" surety, it merely pays for the very same labor and material it would otherwise have to pay as a "payment" surety. Thus while ultimate physical completion may still be assured, the Government has lost the element of timeliness which may be of equal or greater importance than physical completion alone. All of which is to say that the two obligations of the surety are so intertwined as to become one in any practical sense. This relationship justifies the *Henningsen* Court's declaration at page 410 of the Official Report that *Prairie State* "is in point."

POINT FOUR

The ultimate availability of the "contract balance" as salvage is of great importance to sureties and to the Government.

A fundamental error is too often made in regarding the surety on the construction bond as an insurer and thus subject to the law of insurance and its concepts. No mistake could be more detrimental to a clear understanding of the surety's position in the construction industry and in the business world generally.

A surety bond affords no protection whatsoever to the principal himself. This has been overlooked by

the Appellant and the Amicus Street when they talk as if the bankrupt-principal had purchased some kind of insurance coverage protecting him and his general creditors. One of the deeply rooted and historical rights of a surety is to be indemnified or exonerated by its principal for all losses caused it by such principal's act, default or miscarriage. From these long recognized rights of a surety and from long recognized subrogatory rights, very substantial salvage flows to the surety.

The *Prairie State* and the *Henningsen Cases* in this Court, discussed above, were early affirmations of the surety's rights to salvage the contract balance as against strangers to the surety's obligation.

Corporate sureties were first permitted to be accepted as surties on bonds running to the Federal government in 1894, on the very same day when the Heard Act was enacted. (See Title 6 U.S.C. sec. 6 and repealed section 270 of Title 40). The doctrines established by *Prairie State* in 1896 and *Henningsen* in 1908 were widely followed by the lower federal courts and substantially all state courts. The salvage rights deriving from these cases became the warp and woof of the surety underwriter's analysis of the risk and have been relied on to date.

Professor Jules Backman in his "Surety Rate-Making" on page 34, pointed up the importance of salvage to the surety:

> "Surety Premiums Are Not Primarily Contributions To a Fund Out of Which Losses Are Paid. Salvage is Significant In Suretyship. With

insurance there is substituted a certain loss (the cost of the premium) for an uncertain loss (the hazard to which the insured is subject). Thus, with fire insurance the cost is the premium, not the much larger but indefinite cost attending a fire. Again, with automobile insurance the cost is the premium, not the uncertain damages resulting from an accident. For these types of insurance, as well as others, the policyholder's cost is the premium and no more, except in very unusual cases.

Suretyship presents a marked contrast. The payment of the premium by the principal, is in addition to any loss he may suffer from the transaction bonded. The bond does not relieve the principal of his obligation. The surety bond relieves the fears of the obligee—the person to whom, or organization to which a loss must be paid if the principal's obligation is not fulfilled. If a loss does occur and the principal cannot meet it, then the surety makes good. But in effect the surety company often is merely telescoping time. It pays today, with the full right to recover from the principal tomorrow. In the vast majority of cases, the principal meets his obligation or makes good the financial obligation he incurs so that the surety company pays no losses. But even where the surety company must make the payment, it may recover all or a substantial part of its loss payments and claim expenses. Indeed, as indicated in Chapter III, approximately one-third of the losses paid on surety bonds in the past has been recovered through salvage. For insurance lines, on the

other hand, salvage is non-existent or an insignificant factor."

The importance of salvage to the surety was even earlier recognized by Mr. Crist in his "Corporate Suretyship" (1st ed. 1939) on page 136. Another recognition of its importance is to be found in chapter 8.03-.04 of the "Handbook of Architectural Practice" (8th ed., published by the American Institute of Architects in 1958).

It is significant fact that notwithstanding that the contract balances have been available to the surety for purposes of salvage for many years under the decisions of this court, the statistics filed by The Surety Association of America with the various insurance departments of the United States and with the insurance department of the District of Columbia indicate that the loss experience on federal contract work has been considerably worse than on similar non federal work. This undoubtedly is a product of the liberality with which the Miller Act has been construed by this Court and the lower federal courts.

The following statistics are drawn from the yearly figures filed in the various insurance departments, as mentioned above, and have been tabulated by The Surety Association of America. Extracts from these tabulations were published in 71 Yale Law Journal 1274, 1279 n. 26. (The ratio of "loss" costs shown below are in addition to the sureties' expense ratio for "federal taxes" and "other expenses", such as "commission and brokerage expense", "operating expense", "unallocated loss adjustment expense", and "[other] taxes, licenses, and fees". The technical

content of each of these terms can be found in the Regulations on "Uniform Accounting" of the National Association of Insurance Commissioners).

FEDERAL CONTRACT EXPERIENCE —
COUNTRYWIDE U.S.A. —
NET DIRECT BUSINESS — ALL COMPANIES

Calendar Year	Net Premiums Written	Net Losses Incurred	Ratio
1946	$ 5,749,927	$ 56,246	1.0
47	6,850,168	32,893Cr	0.5Cr
48	8,980,178	425,072	4.7
49	10,082,976	1,742,074	17.3
50	10,411,277	1,945,103	18.8
51	21,124,877	5,746,698	27.2
52	21,431,462	5,369,537	25.1
53	16,125,444	8,497,871	52.7
54	14,381,336	9,505,795	66.1
55	16,417,365	9,252,341	56.4
56	16,303,032	10,275,393	63.0
57	18,584,549	8,911,485	48.0
58	22,672,413	9,799,656	43.2
59	18,481,918	11,886,736	64.3
60	18,275,155	15,579,859	85.3
Total Last 5 Yrs.	94,317,066	56,453,129	59.8
Total 15 Yrs. 1946-1960	$225,872,077	$98,960,974	43.8

NON-FEDERAL CONTRACT EXPERIENCE—
COUNTRYWIDE U.S.A.—
NET DIRECT BUSINESS ALL COMPANIES

Calendar Year	Net Premiums Written	Net Losses Incurred	Ratio
1946	$ 16,563,102	$ 879,721	5.3
47	25,097,563	4,311,153	17.2
48	39,563,572	8,593,732	21.17
49	48,496,180	10,708,386	22.1
50	62,392,320	14,363,498	9.1
51	60,674,219	27,874,209	45.9
52	64,559,579	21,058,049	32.6
53	75,879,484	21,910,320	28.9
54	81,576,837	22,180,022	27.2
55	86,575,731	34,475,182	39.8
56	91,327,971	44,004,936	48.2
57	96,416,698	42,695,819	44.3
58	107,909,569	36,454,216	33.8
59	103,660,334	41,810,308	40.3
60	109,439,653	74,789,792	68.3
Total Last 5 yrs.	508,754,225	239,755,071	47.0
Total 15 Yrs. 194[illegible]-1960	$1,070,132,812	$406,106,343	37.9

I to such liberality of construction, this Court now adds another factor—the divorcement of the payment bond surety from its traditional salvage rights in the contract balances in favor of general creditors of bankrupt contractors, it is difficult to envisage what the overall loss experience of the surety industry will be. It will be faced with a condition in the underwriting of contractors on federal public works

for which it has had no broad precedent since the beginnings of corporate suretyship.

Several consequences may ensue:

1. Surety experience on federal contract bonds may necessitate a re-examination of the rate structure with a surcharge on federal contracts. Today the contract bond rate structure makes no distinction between federal and non federal public work contracts. The possibility of such a surcharge is not in the best interests of the United States. Why should it pay more for its necessary bond protection because general creditors who have no responsibility for the progressing of the federal work or the payment of labor or material bills shall have achieved 54 years after *Henningsen* a change of status as a result of a reversal of the Second Circuit in this case?

2. Some surety companies may deem it prudent to withdraw from across the board underwriting of contractors on federal public works contracts. This, too, is not in the interest of the United States. In recent years public works contracts of the United States have been growing larger and larger in size. Under the Regulations of those charged in government with the construction of federal public works such as the General Services Administration, the Corps of Engineers, the Bureau of Yards and Docks, performance bonds in 100% of the price, together with the statutory payment bond under the Miller Act are now widely required. Any withdrawal of surety company underwriting in the federal contract field would make it very difficult for the government to obtain the protection it seeks on

its giant contracts. On such jumbo contracts, wide spread co-suretyship is necessary among companies on the Treasury List of Approved Sureties who are limited in their participation to 10% of their capital and surplus as a maximum. (See sections 10, 11 and the Proviso of 12(a) of Treasury Department Circular 297 and Circular 570.) As a general rule, however, few companies on very large contracts participate in the co-suretyship to the maximum limit of their Treasury Department qualification. If such a narrowing of risk participation on federal contract bonds should occur, the government will lose the benefit of the experience and "know-how" of the surety industry in qualifying bidders, to say nothing of the financial security afforded by the bond.

3. Surety underwriters will undoubtedly tighten up their underwriting requirements for bidders on federal works. Since the unjust enrichment of the general creditors at the expense of the long recognized priority of the payment surety in the contract balance will seriously impair the surety's salvage recoveries, it is reasonable to anticipate that only those contractors of high financial strength will be able to meet the underwriter's tests for the risk before him. A necessary effect of this belt tightening will be that many bidders now meeting current underwriting requirements will no longer be able to do so with a corollary effect on the interests of the government—the base of available competitive bidders on federal public works will be narrowed. Such a contraction in the number of qualified competitive bidders in economic theory,

at least, will bring about a price level higher than that produced by wider based public bidding.

4. Finally, and auxiliary to the last point, destruction of the salvage rights of the surety in the contract balance will also set up through the operation of 3. above, a counterweight to the policy of government to achieve the widest distribution of public and other contract work among the "small business" community. Very few so called small business men will be able to qualify for surety bonds under conditions where the surety risk has been converted to an insurance risk.

It has been the policy of the Government to encourage and assist the participation of small business concerns on both prime and subcontracts. See 41 U.S.C.A. App. Rules and Regs. § 1-1.702 (Supp. 1961) which states the following:

> "(a) *General policy.* It is the policy of the Government to aid, counsel, assist, and protect, insofar as possible, the interests of small business concerns in order to preserve free competitive enterprise; and to place with small business concerns a fair proportion of the total Government purchases and contracts for property and services (including contracts for maintenance, repair, construction, and research and development).
>
> * * * *
>
> (b) (2) Small business concerns shall be afforded an equitable opportunity to compete for prime contracts and subcontracts."

Insofar as the construction industry is concerned a "small business concern" is defined as one whose "average annual receipts for the preceding three fiscal years do not exceed $7,500,000.00. [Title 41, 1-1.701-1 (a) (2) (i)] It is highly doubtful whether any contractor thus qualifying as a "small business" could put up the collateral or other indemnities that would be required by a surety which knew that it could not look to the contract balance in case of his default.

Both the Miller Act and the Heard Act before it had as one of their principal purposes the implementation of competitive bidding by broadening the base of available contractors on whom the Government might rely for public works with full assurance of fully-paid completion. In these days when the prevention of monopoly and the artificial narrowing of competition in any industry have become a matter of judicial as well as political concern, it becomes all the more important that the "competitive base" be not at all diminished, particularly where to do so would be to lead to increased costs.

POINT FIVE

All other considerations aside, the surety has a primary right to the fund by virtue of the assignment contained in the indemnity agreement between it and its principal.

In order to induce the surety to execute the Miller Act bond required by the statute, the contractor in the instant case long prior to his bankruptcy delivered to the surety a duly executed written assignment of all monies under the contract which the contractor

entered into with the United States. The pertinent part of this assignment reads as follows:

"5. If any such bond be given in connection with a contract, to assign, transfer and set over, and the Indemnitors do hereby assign, transfer and set over, to the Company, surety or sureties executing said bond or bonds, such assignment to become effective as of the date of said bond or bonds, but only in the event of any such abandonment, forfeiture or breach as aforesaid—

a. All their right, title and interest in and to all machinery, plant, tools and materials which are now or may hereafter be upon the site of the work embraced in such contract, or elsewhere for the purposes thereof, including all materials purchased or ordered for said contract, whether such materials be completely manufactured or not;

b. All their right, title and interest in and to any and all subcontracts let or which may be let in connection with such contract;

c. Any and all percentages of the contract price retained on account of said contract, and any and all sums that may be due under said contract at the time of such abandonment, forfeiture or breach, or that thereafter may become due;

d. All their rights in, and growing in any manner out of, said contract or said bond or bonds."

Such assignments have long been recognized as valid between the parties to the assignment. See

Martin v. *National Surety*, 300 U.S. 588; *U. S.* v. *Munsey Trust Co.*, 332 U.S. 234 (1947), p. 237, note 1. See also *Lacy* v. *Maryland Casualty Company*, 32 F. 2d 48 (CA 4, 1929) and *U. S.* v. *Aetna Casualty & Surety Co.*, 338 U.S. 366 (1949); 4 *Corbin*, Sections 869, 906.

It is thus quite clear that, by virtue of the assignment, the contractor had no rights in the retained balance to which the trustee could possibly succeed. See *National Surety Co.* v. *Lane*, 45 App. D. C. 776; *Philadelphia Bank* v. *McKinlay*, 72 F. 2d 89; *Moran* v. *Guardian Casualty Co.*, 76 F. 2d 438; *California Bank* v. *U.S. Fidelity & Guaranty Co.*, 129 F. 2d 751; *Lyttle* v. *National Surety Co.*, 44 App. D. C. 1936; cf. *Alabama-Tennessee Natural Gas Co.* v. *Lehman-Hoge & Scott*, 122 F. Supp. 314 (N. D. Ala. 1954); *In re Allied Products Co.*, 134 F. 2d 725 (6th Cir.), cert. den. 320 U.S. 740 (1943); *Salem Trust Co.* v. *Manufacturer's Finance Co.*, 264 U.S. 182 (1924).

Further, and perhaps of even greater importance, as a result of its failure to pay labor and material bills, the contractor had breached his contract with the Government (see *Martin* v. *National Surety*, 300 U.S. 588, discussed at p. 14 hereof) and had thus cut off his rights to any further payment. See *Fidelity & Deposit Co.* v. *N.Y. Housing Authority*, 241 F. 2d 142 (1957); *U.S. Fidelity & Guaranty Co.* v. *Triborough Bridge Authority*, 297 N.Y. 31, 37 (1947); cf. *U.S.* v. *Bess*, 357 U.S. 51, 55; *U.S.* v. *Durham Lumber Co.*, 363 U.S. 522.

Conclusion

It is respectfully urged that the determination of the Court of Appeals in the instant case was completely correct and that the surety, by paying all labor and material claims, became entitled both as a matter of law and equity to reimbursement from the contract balances, and that these rights are superior to any claim to a windfall which the trustee, representing the general creditors of the bankrupt, might have.

As a result of the aforegoing it is respectfully submitted that the determination of the Court of Appeals herein should be affirmed and the fund ordered turned over to respondent, Reliance Insurance Company.

Respectfully submitted,

David Morgulas,
Amicus Curiae, on Behalf of The Association of Casualty and Surety Companies.

Certificate of Counsel

I hereby certify that I have served a copy of the foregoing brief on Raymond T. Miles, Esq., 942 Ellicott Square, Buffalo 3, New York, petitioner's counsel of record, and John G. Street, Jr., amicus curiae, 625 Forth Worth National Bank Building, Fort Worth, Texas, by depositing a copy of the same in a United States mail box, postage prepaid, addressed to each of the above counsel, at the post office addresses set forth above, on October 5th, 1962.

David Morgulas,
Amicus Curiae, on Behalf of The Association of Casualty & Surety Companies.